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Big Steel's Imbroglia

Illusory Profits and Real Taxes

By Sue Siferd and John Talbott

Financial publications would certainly lead one to place little credence in the contention that there is currently an erosion of business capital in this country, caused by confiscatory taxes, which is precluding industrial growth.

"These Republic Steel fourth quarter 1978 earnings were 60 cents above my estimate" confessed one analyst at a major brokerage concern.¹

"Our most likely earnings estimates for 1979 assume 20 percent earnings gains for most of the major steel companies while our high end 1980 forecast shows earnings rising by another 50 percent," noted another.²

Despite the euphoria associated with such comments, it may be argued that in periods of inflation our existing tax laws provide for confiscatory tax rates well above the statutory limit. These confiscatory taxes stem from businesses' unwillingness and/or inability to deal with the inflation effect on earnings. What legislator in his right mind, for example, is going to vote for significant tax relief for corporations who continue to report record annual earnings?

Such earnings reports, in fact, are the basis of "obscene profit" remarks which appear to have led to an anti-business environment in the country at large. By masking the erosion of capital with spurious profits, significant tax reform is stymied. In essence, the time has come to realize that corporate external reporting, based on historic costs, is a major contributor to the stagflation affecting our country. The purpose of this article is to examine that contention.

The Study:

To support the position, 1977 annual reports and 10-K's of 13 major iron and steel producers were studied. Table One shows the 13 companies in our study and their total assets at December 31, 1977, as well as their reported net income after tax and their return on assets for 1977.

Table Two shows net income, replacement cost net income, common stock dividends, and excess of common stock dividends over replacement cost net income. Admittedly, the replacement cost figures generated via Accounting Series Release 190 are no panacea. Realistically, replacements will take place over many years and the new plant will provide additional revenue generating services and operating efficiencies. As a result, the replacement cost net income may paint a more dire picture than reality would warrant.

Bearing this caveat in mind, however, Table Two results are indicative of the erosion of business capital. Only four of the companies generated a positive replacement cost net income. Moreover, the common stock dividends for twelve of the companies exceeded the replacement cost net income. In fact, Carpenter Technology was the only company in the study whose common stock dividends did not exceed replacement cost net income.

Table Three compares the additional replacement cost expense as a percentage of income before tax, income after tax, and common stock dividends. For the twelve companies

reporting an after tax profit, the additional replacement cost expense was at least one hundred percent for seven of the companies. Perhaps more informative, however, the replacement cost expense was no less than sixty percent of reported after tax income for any of the companies studied.

The staggering implications of these figures may be more readily understood if we arbitrarily assume that the "true" costs are only one-half as great as the reported replacement costs would indicate. Even under these assumptions, a significant portion of net income is illusory in nature and is neither available for dividends nor for capital expansion projects but is being clandestinely employed to replace higher priced plant, equipment and inventories.

In Table Four we have listed the primary earnings per share, replacement cost earnings per share, and dividends per share. In light of the fact that all corporations with the exception of Carpenter Technology were engaging in liquidating dividends, investors should cast a wary eye at the early 1979 market recovery of a number of the steel stocks.

The Trigger

This recovery, in fact, stems primarily from the subsidization of the steel industry through the "trigger" price mechanism which sets an arbitrarily high price for foreign steel. The combination of the trigger with high demand has raised steel prices sharply in an era when the administration anathema is inflation, and will exacerbate pricing problems for other U.S. industries that must employ steel in their manufacturing processes. More specifically, these industries will now find themselves at a similar competitive disadvantage with their foreign counterparts, as steel did earlier. While the exact impact on the economy as a whole is debatable, it is safe to assume that aggregate results are far from salutary as a result of subsidizing a particular industry.

The trigger price fiasco also demonstrates once again that historical costs which provide for illusory profits and confiscatory taxes in periods of rampant inflation are a nemesis to the economy in general. This is due, of course, to the way that the tax system handles depreciation. If a company spends \$1-million on labor, it deducts the dollars against sales revenue of approximately equal purchasing power.

TABLE ONE
(Figures in 1,000's of Dollars)

Name of Company	Total Assets At Dec. 31, 1977	Net Income for 1977	Return on Assets
Armco Steel Corporation	\$ 2,882,754	\$119,832	4.16%
Bethlehem Steel Corporation	4,898,900	(448,200) ⁽¹⁾	-9.15%
Carpenter Technology Corporation ⁽²⁾	263,999	33,753	12.79%
The Cleveland-Cliffs Iron Company	354,615	26,111	7.36%
Copperweld Corporation	268,083	16,307	6.08%
Cyclops Corporation	333,332	8,992	2.70%
Inland Steel Company	2,302,352	87,801	3.81%
Kaiser Steel Corporation	961,440	4,544	0.47%
Lukens Steel Company	188,241	12,070	6.41%
National Steel Corporation	2,827,646	60,125	2.13%
Republic Steel Corporation	2,406,330	41,031	1.71%
United States Steel Corporation	9,914,400	137,900	1.39%
Wheeling-Pittsburgh Steel Corporation	765,691	(25,630)	-3.35%
Totals	\$28,367,783	\$125,896	0.44%

(1) Bethlehem reported a loss of \$120-million before taxes (a credit) and nonrecurring items; the nonrecurring item included a \$750-million estimated cost of closedown of facilities.

(2) Fiscal Year ended June 30, 1978.

Source: 10-K's and Annual Reports, 1977.

TABLE TWO
(All figures in 1,000's of dollars)

	Net Income for 1977	Replacement Cost Net Income ⁽¹⁾	Common Stock Dividends	Excess of Common Stock Dividends over Replacement Cost Net Income
Armco	\$119,832	(\$25,168)	\$53,310 ⁽²⁾	\$ 78,478
Bethlehem	(448,200)	(836,200)	65,500	901,700
Carpenter	33,753	12,353	10,216	(2,137) ⁽⁴⁾
Cleveland-Cliffs	26,111	10,467	12,250	1,783
Copperweld	16,307	3,693	6,732	3,039
Cyclops	8,992	(31,977)	2,774 ⁽²⁾	35,781
Inland	87,801	(199)	52,654 ⁽²⁾	51,314
Kaiser	4,544	(76,009)	10,449 ⁽²⁾	86,499
Lukens	12,070	1,633	4,128	2,495
National	60,125	(42,875)	48,232	91,107
Republic	41,031	(137,492)	25,892	163,384
U.S. Steel	137,900	(362,100)	182,400	544,500
Wheeling-Pittsburgh	(25,630)	(75,204)	0 ^{(2) (3)}	75,204

(1) Replacement Cost Net Income = Net Income minus Additional Replacement Cost Expense. Additional Replacement Cost Expense is determined from the 10-K reports and is the sum of the excess of Replacement Cost of Goods Sold and Replacement Cost Depreciation Expense, over Historical Cost of Goods Sold and Depreciation Expense. The tax effect of the Additional Replacement Cost Expense is not reported since such costs are not a deduction under present income tax laws. Appendix A reports this information.

(2) Also paid a preferred stock dividend.

(3) Paid one-half preferred dividend.

(4) Carpenter Technology Corporation is the only company in our study whose Common Stock Dividends did not exceed Replacement Cost Net Income.

Source: 1977 Annual Reports, 10-K's and our computations.

(5) The tax effect of additional Replacement Cost has not been considered in these computations because present Federal Income Tax Laws do not allow this expense as a deduction for tax purposes. See Appendix A for the hypothetical tax effect.

Corporate external reporting based on historic costs is a major contributor to stagflation in the economy.

If the company spends the same \$1-million on a building, however, it will soon be matching the depreciation charge against inflated sales dollars of reduced purchasing power. The resultant products, of course, are spurious profits and excessive tax bills. While this process hurts all business, it is particularly detrimental to industries such as steel with lengthy capital turnover.

In an interview, *Forbes* magazine asked U.S. Steel's vice president-controller, Bracy Smith, whether the steel industry has been hurt by the fact that its profits were overstated. "I suspect that it has," Smith said, "because people say, 'Hell, you're making this much money; why do you need more?'"³

Politicians, of course, are extremely susceptible to this type of logic and their historical attitude toward steel over the past twenty-five years is ample indication of the ominous implications of fictitious figures.

In 1952, for example, Truman seized the steel industries to prevent what he deemed to be inordinate profits and a wage-price spiral. In 1962, Kennedy castigated U.S. Steel publicly over a proposed price increase of less than four percent and in 1972 Nixon heaped a great deal of "jawboning" on the industry. Of more recent interest was the initial Carter posture of disparaging steel over a proposed price increase which belatedly gave way to the trigger mechanism as layoffs in the industry increased and political pressure mounted.

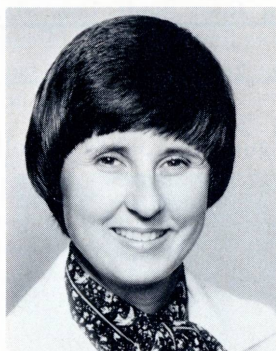
Whenever demand for American steel placed the steel industry in a position to get higher prices and profits, the government forced it to settle for less.⁴ Those decisions initially took their toll in such events as Bethlehem Steel's multi-million dollar write-off of its outdated Lackawanna, New York plant and will soon be causing economic dislocations as a result of market interference associated with the "trigger" prices.

Both types of events could possibly have been avoided with more liberalized depreciation rules or other tax policies which would have benefited the economy in general. The need for such policies is evident if one examines the replacement cost figures generated via ASR 190.

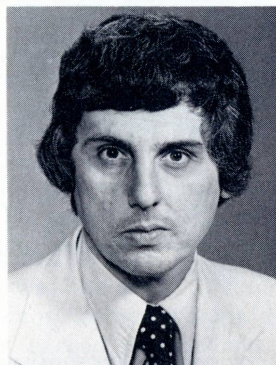
In essence, the dissemination of such figures via financial publications as opposed to their obfuscating position within 10-K's might have proved an impetus for tax reform which would have provided for a healthy domestic steel industry and obviated the need for the trigger mechanism which now threatens widespread economic dislocations.

Why Not Management:

Intuitively, one would expect management to adopt those accounting techniques which would reflect economic reality and strengthen the cor-



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porate position vis-a-vis ubiquitous governmental taxing units. On closer inspection, however, it appears that management often favors high fictitious earnings as opposed to lower real earnings and attempts to employ those apocryphal figures to cement its position within the company and to increase personal remuneration.

There have been several studies which corroborate these contentions. Duvall and Austin, for example, found that managers of firms with depressed earnings and stock prices are more likely to find themselves thrown out of office by dissident stockholders.⁵

Lee Seidler, of New York University, expressed it succinctly: "I would suppose the fact that management holds stock options and things of that sort may sway their judgment."⁶

Conclusion:

Reporting of inflated profits by industries such as steel has resulted in real tax rates of an inordinate magnitude which have diminished steel's competitive position vis-a-vis countries such as Japan whose tax system imposes no special burden on capital intensive industries. Moreover, pressures on corporate management in the earnings per share arena appear to have perverted the very group who should have lobbied for more liberal tax rules to combat the competitive decline.

The scenario that has developed in steel is actually somewhat frightening. A decline in a basic industry results in political pressure to subsidize the industry. These subsidization efforts in turn lead to a decline in competitive position for steel processors who in turn demand political help which further fuels inflationary force. As tables two, three and four indicate, the steel industry does need help. The crux of the matter is that profit figures reported by management appear to be one of the prime reasons that the help is in the form of triggers and not taxes. The resultant product may well be economic stagnation through protectionism.

NOTES

¹"Heard on the Street," *The Wall Street Journal*, January 18, 1979, p. 37.

²*Ibid.*

³"Steel: Biting the Bullet," *Forbes*, December 1, 1977, p. 36.

⁴"Helping American Steel," *The Wall Street Journal*, October 17, 1977, p. 26.

⁵R.M. Duvall and D.V. Austin, "Predicting the Results of Proxy Contests," *Journal of Finance*, September 1965, pp. 464-471.

⁶"Steel: Biting the Bullet," *op. cit.*, p. 35.

TABLE THREE

Additional Replacement Cost Expense as a Percentage of

Name of Company	(a) Income Before Tax	(b) Income After Tax	(c) Common Stock Dividends
Armco	119.2%	121.0%	272.0%
Bethlehem	— ⁽¹⁾	— ⁽²⁾	592.4%
Carpenter	32.2%	63.4%	209.5%
Cleveland-Cliffs	39.7%	59.9%	127.7%
Copperweld	54.6%	77.4%	187.4%
Cyclops	326.5%	455.6%	1476.9%
Inland	96.2%	100.2%	167.1%
Kaiser	— ⁽¹⁾	1772.7%	770.9%
Lukens	47.2%	86.5%	252.8%
National	151.0%	171.3%	213.6%
Republic	429.9%	435.1%	689.5%
U.S. Steel	490.7%	362.6%	274.1%
Wheeling-Pittsburgh	— ⁽¹⁾	— ⁽²⁾	0 ⁽³⁾

(1) Reported loss before tax

(2) Reported net loss

(3) No common stock dividends issued

Source: 1977 Annual Reports, 10-K's, and computations.

TABLE FOUR

Name of Company	Primary Earnings Per share	Replacement Cost Earnings Per Share ⁽¹⁾	Dividend per Share of Common Stock	Average Number of Shares of Common Stock Outstanding
Armco	\$ 3.80	(\$1.088)	\$1.80	29,700,000
Bethlehem	(\$10.27)	(\$19.15)	\$1.50	43,665,000
Carpenter	\$ 3.97	\$1.452	\$1.20	8,509,000
Cleveland-Cliffs	\$ 4.26	\$1.709	\$2.00	6,124,728
Copperweld	\$ 2.91	\$0.658	\$1.20	5,608,000
Cyclops	\$ 3.69	(\$15.29)	\$1.30	2,158,394
Inland	\$ 4.23	(\$1.086)	\$2.60	20,267,000
Kaiser	\$ 0.51	(\$11.00)	\$1.50	6,996,891
Lukens	\$ 4.68	(\$0.633)	\$1.60	2,579,000
National	\$ 3.12	(\$2.225)	\$2.50	19,273,000
Republic	\$ 2.54	(\$8.496)	\$1.60	16,183,000
U.S. Steel	\$ 1.66	(\$4.362)	\$2.20	83,011,299
Wheeling-Pittsburgh	(\$ 7.70)	(\$20.17)	0	3,728,575

(1) Replacement Cost EPS = (Replacement Cost Net Income — Preferred Stock Dividend) divided by weighted average number of shares of common stock.

Source: Annual Reports, 10-K's, and computations.

APPENDIX A

(All figures in 1000's of dollars)

	Net Income for 1977	Replacement Cost Net Income net of Tax Effect ⁽¹⁾	Common Stock Dividends	Excess of Common Stock Dividends over Replacement Cost Net Income Net of Tax Effect ⁽²⁾
Armco	\$ 119,832	\$ 44,432	\$ 53,310	\$ 8,878
Bethlehem	(448,200)	(649,960)	65,600	715,560
Carpenter	33,753	22,625	10,216	(12,409)
Cleveland-Cliffs	26,111	17,976	12,250	(5,726)
Copperweld	16,307	9,748	6,732	(3,016)
Cyclops	8,992	(12,312)	2,774	15,086
Inland	87,801	42,041	52,654	10,613
Kaiser	4,544	37,344	10,449	(26,895)
Lukens	12,070	6,643	4,128	(2,515)
National	60,125	6,565	48,232	41,667
Republic	41,031	(51,801)	25,892	77,693
U.S. Steel	137,900	(122,100)	182,400	304,500
Wheeling-Pittsburgh	(25,630)	(51,408)	0	51,408

(1) Statutory tax rate of 48% assumed.

(2) Replacement Cost Net Income net of tax effect exceeded Common Stock Dividends for Carpenter, Cleveland-Cliffs, Copperweld, Kaiser, and Lukens.

Appendix A has been prepared under the hypothetical assumption that all productive assets and inventories were replaced at their replacement cost. Under this assumption, additional Replacement Cost expense *would* be deductible for federal income tax purposes. Using the statutory tax rate of 48% for 1977, we have computed the Replacement Cost Net Income, net of taxes. As Appendix A illustrates, a comparison of common stock dividends with Replacement Cost Net Income net of tax effect shows eight of thirteen companies paying a common stock dividend in excess of Replacement Cost Net Income net of tax effect.

It should be further noted that because of Investment Tax credits, present and prior operating losses, losses due to discontinued operations, and other financial events, many of the steel companies did not pay taxes at the statutory federal income tax rate of 48% in 1977.